EXCERPTED FROM:
BANCBOSTON ROBERTSON STEPHENS CONFERENCE

THE WALL STREET TRANSCRIPT
Questioning Market Leaders For Long Term Investors

THE FOLLOWING REPORT IS TAKEN IN FULL FROM
THE WALL STREET TRANSCRIPT

CEO/COMPANY INTERVIEW

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Founded 1963
Published by Wall Street Transcript Corporation
100 Wall Street, New York, NY 10005

CEO INTERVIEW

CEC Entertainment, Inc. (CEC)



At the helm of CEC Entertainment since 1986, **RICHARD M. FRANK** has Engineered a strong turnaround of the company's kid-oriented, 337-unit Chuck E. Cheese's brand, including an aggressive remodeling program, the opening of 25-30 new stores in 1999 and introduction of a wide range of new food and entertainment initiative. A native of New York state, the 51-year old Mr. Frank spent 12 years in various positions with S&A Restaurant Corporation (Steak & Ale and Bennigan's) from 1973 to 1985. He was S&A's Executive Vice President and Chief Operating Officer in 1985 when he joined CEC Entertainment in Irving, Texas as President and Chief Operating Officer. Mr. Frank is a 1970 graduate of Hope College, Holland, Michigan with a Bachelor of Arts degree in English. He has three children and is a significant contributor to the M.D. Anderson Cancer Center in Houston in memory of his late wife.

SECTOR – RESTAURANTS

(HAR610)(RS33) TWST: Let's start out by your giving us a brief overview of CEC Entertainment Inc. — the company's history, products, services, customers, those kinds of things, please?

Mr. Frank: Our primary brand today is of course the Chuck E. Cheese restaurant locations across the United States. It's really a unique blend of an entertainment and food experience targeted at families with children of about two to 12 years of age.

We've been around since 1977, over 22 years out in the marketplace. We currently have 337 stores operating in 44 states. This past 12 months, we've had about 75 million guests or customers come through our stores with about 50 million of those being young children.

TWST: What form of entertainment do you provide?

Mr. Frank: The bulk of our entertainment falls into two categories. We have what we refer to as a showroom where there's animated entertainment, robotic entertainment, that really entertains the kids and the families for the meal portion of the occasion at a Chuck E. Cheese. We are in the process of changing that entertainment as we move to the future. And then the second portion of the entertainment is games, rides and attractions where the kids win tickets based on their skill levels and scores they achieve playing the games. Then they return those tickets at the end of the experience for prizes to take home.

TWST: You said you're changing one of those experiences. What is the new entertainment?

Mr. Frank: Yes, we constantly evolve all of the entertainment. Today about 65% of our revenues come from food, from food and beverage, but 35% is on the entertainment side. And although that

might seem like it's more of a restaurant type of occasion, what really drives our frequency, what really drives our sales is in fact the entertainment piece. So we're constantly reinvesting in changing the entertainment aspects of the concept.

Right now we're in a the early stages of a potentially big initiative that we refer to as "Studio C," and that is the entertainment component in the showrooms which I previously mentioned. In Studio C, we reduce our show from five or six robotic characters to one character, that being Chuck E. Cheese.

Then, the difference is that the stage entertainment now becomes very, very interactive. We have what we refer to as a blue screen stage where the kids actually come up on the blue screen stage. Through computers, we can change the TV monitors within the showrooms and create different backgrounds and scenery. The kids actually get in front of that scenery and sort of create their own entertainment, and this is superimposed on the TV monitors.

TWST: Do the kids pay for the entertainment or how do you get revenue from the entertainment aspect?

Mr. Frank: We try to blend our entertainment into both a mix of free entertainment, free attractions, as well as the games and rides, which do generate revenue. The showroom activity, including the "Studio C," which we're in the process of converting, is a free entertainment feature and we think a real point of difference for us.

Also out in our game room area where we do have all the games, rides and attractions, we have what we refer to as "Sky Tubes." These are tubes that kids crawl around in suspended from the ceiling, and that's a major hit with kids. The "Sky Tubes" are also a major free attraction.

TWST: How many stores are you planning to open this year?

Mr. Frank: We'll open approximately 30 locations this year, and probably increase that slightly in 2000.

TWST: I just read that you're pending purchase of certain assets of Discovery Zone.

Mr. Frank: Correct. We have actually already closed on that transaction.

TWST: Could you discuss that?

Mr. Frank: Sure, we purchased certain assets of Discovery Zone in late July for approximately $19 million. You can break the Discovery Zone purchase down into two, three key areas. First, we purchased the name of Discovery Zone, and for that matter all the intellectual properties owned by DZ. Secondly, we purchased what we refer to as the FF&E, the furniture, fixtures, and equipment which included all the games in their stores which totaled about 150 locations. And then lastly, we purchased 13 owned properties, as well as two pieces of underdeveloped land, and seven leases.

What we intend to do is convert the seven leased properties along with three of the owned properties to Chuck E. Cheese's. So we'll probably end up with about 10 additional Chuck E. Cheese's restaurants and sell the remaining real estate.

TWST: How many of your stores are franchisees?

Mr. Frank: Only 55 locations today are franchise, and our company base is 282 stores with a total system of 337 locations.

TWST: What are the most significant trends, developments, changes, and so forth you anticipate in your marketplace over the next several years?

Mr. Frank: We think that the biggest trends coming our way is first, we see the demographics continuing to work in our favor. Today, although it's

not a record number of kids from historical levels, the number of kids in the two to 12 age bracket in the U.S. is at a very, very high level. And the birth rate, although somewhat flat right now year on year, continues to be at a very high level. So demographically, we feel that the trend, given the positioning of our business, is very, very favorable.

Secondly, we think that there's going to be a continued, and probably increased emphasis in the country in terms of family time spent together. We think the resource that families in the country today have the least of is time. And we think that therefore families seeking out quality entertainment experiences and time that they can be together as a family unit is extremely important.

The third trend that will probably affect us is that kids are simply growing up in a different world today. The children coming to Chuck E. Cheese are more high tech, they're more sophisticated. This translates directly to what we have to provide as they become more sophisticated to really keep the entertainment alive, fresh, and even leading edge, to some degree for them to really enjoy the Chuck E. Cheese experience and want to continue to come back.

And then lastly, as with any business in the marketplace today, it's going to be a game of creating value. The entire marketplace, particularly, in our equation, the parents, just demand a high value for the experience that they're paying for.

TWST: What's the average size of a check at Chuck E. Cheese?

Mr. Frank: We experience a per person average, including the games, rides, and attractions of about $9 per person, and our average party size is a little bit over four. So an average check would be about $35-$40 for a family of four or five people.

We think it's an excellent value, especially when you consider that includes both the meal experience with drinks and entertainment for the entire family at $9 a person. When you compare that to going to movies and having dinner, or whatever, we think it's a nice position relative to value compared to other opportunities.

TWST: What are the greatest opportunities for Chuck E. Cheese over the next several years? Is there a chain of events that could lead the company to really beat expectations in the future?

Mr. Frank: I think our greatest opportunity is number one, like any restaurant type company, we've got to continue to keep our core stores or our same store sales on the positive side of the ledger. We've had a very healthy system now for the last three or four years and it's going to be very, very important for us to continue to maintain that as we move forward.

Probably our second opportunity right behind that is to continue to expand our store base. We want to grow our number of stores by about 10% a year. We think that there's still at least an additional 200-250 locations here in the U.S., so we see a real opportunity to further grow the Chuck E. Cheese brand.

And then lastly, we'd like to believe, and are starting to believe, that there may be a meaningful opportunity for us over time on the licensing side of things. We have entered Chuck E. Cheese, the character, in licensing studies or character studies here in the U.S., and Chuck E. always finishes in the top 5%. And these are independent studies of characters in the food and entertainment business. So we're starting to look for opportunities from a licensing standpoint with our character just given the strong brand awareness and how well Chuck E. is liked by young children.

TWST: Are you going to expand internationally at all?

Mr. Frank: We have done some there. It is limited. Today we've got a store in Guatemala. We've got two stores in Chile. We've got a store that is close to going under construction in Saudi Arabia, but our international presence is not of any great magnitude. We think the potential for international expansion for our company is undetermined at this point in time.

TWST: What are the major concerns that CEC faces now and in the future?

Mr. Frank: I don't know that we see any major concerns. I think that's probably in part because Chuck E. is as healthy today, the business is as healthy today, as it's been in the 22 years that it's been in operation.

At the same time, that's not to mean that I think we're complacent. I know that the things that I focus on and think about a lot in terms of the future is, number one, the things that we need to do to continue to retain quality employees. It's a difficult labor market today. Unemployment is very, very low in almost every market. The real challenge is to hang on to the really good people once they're on board.

I think that, not unlike any other company, we've also been blessed here over the last number of years with a great economy. Even though I think that to some degree Chuck E. has a great floor in a difficult or a recessionary type environment in that we have a lot of party business in birthday party specifically, a slowdown in the economy could impact us even if only to a small degree.

Thirdly, as is the case I think with probably any business, we're going to have to continue to monitor the marketplace, and specifically, competition. We must keep our eye on what competition might mean to us in the marketplace and what we might need to do to respond.

And then I think lastly, but certainly not necessarily least important, is sometimes the decisions that are made in Washington.

TWST: What sets CEC apart from your competition? What are some of your other competitive advantages?

Mr. Frank: I think that in terms of competitive advantages, I think the first is that we ought to know the business. We've been out there since 1977, over 20 years now. We've been through some cycles. We've had great times, we've had difficult times. But I don't know that there's anyone that understands the family entertainment and restaurant business any better than we do.

Secondly, I think that Chuck E. is without a doubt a leader in its market niche. We've got a strong brand identity. We've got a lot of penetration. As I said earlier, we're in 44 states today and we've got a lot of restaurants clustered in a lot of the larger metropolitan areas. That gives us significant advertising as well as operating and purchasing efficiencies. So I think that's a real competitive advantage, too.

Thirdly, I think that, given the performance of the company, really over a number of years, our balance sheet is extremely strong. As an example, our debt to cap ratio is less than 15%. So we're a company that's very, very under leveraged. Additionally, we have strong cash flow and I think what that allows us to do is continue to be very flexible and reinvest in our business as we need.

And then lastly, I think our competitive advantage also ties to the strength and depth of our people. We have, and I think the significance here is probably more on the operating side, because obviously those are the folks that really touch the customer day in and day out, a real advantage with the depth of our management team.

Today, we've got five regional vice presidents who manage multi-states for us. Those

people have been with Chuck E. Cheese, with our company, almost 12 years on average. Our district managers, who are our folks that handle approximately eight stores, have been with Chuck E. Cheese almost 11 years on the average. A general manager in our business is responsible for just one store. They've been with us for about six and a half years. And then our second line, like assistant managers, have been with us nearly four years.

I think if one were to look at the restaurant industry, to have assistant managers who have been with a single company on average for four years or nearly four years, one would find that our numbers are very, very strong. We think this speaks to the depth of people that we have in our organization. At the end of the day, we're only as good as the people that are out there to open the doors every day. And we think we have some of the best people in the industry.

TWST: Any opportunities for improvement within the company? Any weaknesses that have to be met?

Mr. Frank: Again, I don't know that I feel that we have any significant weaknesses today. But I think, without a doubt, our biggest challenge, and it will always be our biggest challenge, is as kids do become more sophisticated, they're going to demand a higher and higher level of entertainment value. And that's going to cause us to need to continue to reinvest in our business which challenges us to get good returns on that newly invested capital. We need to do this in a way that continues to build sales and continues to allow us to be the leader in the family entertainment business.

TWST: What are your specific goals for Chuck E. Cheese over the next several years?

Mr. Frank: We think that they're probably two or threefold. Number one, we want to obviously continue to have positive comp store sales, to keep the strong health and vitality in our existing store base. Secondly, we want to grow our system in terms of new units by approximately 10%. And then thirdly, as a management team, we continue to be committed to growing earnings per share at a rate of at least 20-25% each year.

TWST: How do you feel about your current stock price?

Mr. Frank: That's always a difficult one for me. I tend to think we're probably better off letting Wall Street and the investment community determine the value of the company. What I would say, I guess, is we've been a public company now about 10 and a half years. If you look at our performance over that 10 and a half year period, our stock price has appreciated on a compound annual basis better than 36%, while our earnings per share on a compound annual growth basis has increased over 46%.

So number one, I'd say that we're proud of that performance and we think that our shareholders have done well, and we're committed to doing our best to ensure that happens in the future.

The second thing I'd point out is, and it probably speaks more to not only what I believe but also what our board believes, is that over the last five or six years, we have bought back a total to date of about $60 million worth of our stock. Just within the last 30 days we announced an additional buy back that our Board has approved of up to $25 million.

So as we've grown our share price in excess of 35% a year over the last 10 and a half years, we've also recently been out in the market buying it back because we believe over the long haul that we're going to continue to grow earnings and we think it's a good long-term investment. And I think that probably speaks as loudly as we can as management, as a Board, in terms of what we think

the prospects for the company look like as we move to the future.

TWST: Thank you.

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(The Wall Street Transcript - October 1999)

Date of Origin: October, 1999
Archived: 1-10-13
Submission by ChuckEZone
Version 1.0